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Conference Call Transcript

AAPL - Q2 2006 Apple Computer, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good day and welcome to this Apple Computer second quarter financial results conference call. Today's call is being recorded. At this time for opening remarks and introductions, I would like to turn the call over to Nancy Paxton: Senior Director, Investor Relations and Corporate Finance. Please go ahead.

Nancy Paxton *- Apple Computer - Senior Director IR & Corporate Finance*

Thank you. Good afternoon and thanks to everyone for joining us today. Speaking today is Apple CFO Peter Oppenheimer, and he'll be joined by Apple COO Tim Cook, and Apple treasurer Gary Whipfler for the Q & A session with analysts. Apple's second quarter spans 13 weeks compared to the 14 weeks spanned by our first quarter this year.

Please note that some of the information you'll hear during our discussion today will consist of forward-looking statements regarding revenue, gross margin, operating expenses, other income and expense, taxes, earnings per share, Apple's retail initiatives, demand for Macintosh computers, future products, including Intel-based Macs and non-cash stock-based compensation expense. Actual results or trends could differ materially from our forecast. For more information please refer to the risk factors discussed in Apple's Form 10-K for 2005 as well as the Form 10-Q for the first fiscal quarter.

Please also note that any non-GAAP financial measures included in today's call should be viewed in addition to and not in lieu of Apple's GAAP results. A reconciliation of any GAAP and non-GAAP measures discussed will be posted on Apple's website at www.apple.com/investor. In connection with SEC rules on corporate disclosure, Apple is making this analyst call open to the media and general public by broadcasting the call live over the internet.

And with that I'd like to turn the call over to Peter Oppenheimer for introductory remarks.

Peter Oppenheimer *- Apple Computer - CFO*

Thank you Nancy. Thank you for joining us.

We are very pleased to report March quarter results that exceeded our guidance for both revenue and earnings. The quarter's revenue of $4.36 billion was the second highest in Apple's history, topped only by our record December quarter results and grew 34% year-over-year. These results were driven by continued strong growth in our Music business and solid performance in our Mac business during the transition to Intel. Operating margin for the quarter was 12.1%, and net income was $410 million, or $0.47 per diluted share on a GAAP basis.

Excluding the impact of 42 million in non-cash stock-based compensation expense, operating margin was 13.1%, net income was 440 million and diluted earnings per share were $0.50. The quarter's non-GAAP operating margin was the second-best ever for Apple and demonstrates the leverage in our business model. I'd like to first talk about our Mac business, which represented 50% of our total quarterly revenue, and increased 7% year-over-year. Mac units were up 4% year over year to 1.11 million, and ending channel inventory was within our target range of 4 to 5 weeks.

We continued to be very happy with our progress in the Intel transition. We have introduced the Mac Pro, new iMac and new Mac mini with Intel processors and we are solidly on track to have the entire Mac product line transitioned by the end of this calendar year. In January, we indicated that we have seen a pause in customer demand in the December quarter, as customers began to anticipate the introduction of the Intel Mac. And we said that we were factoring the transition into our guidance for the March quarter.

As we anticipated, this pause was even more evident during the March quarter and was generally observed in three areas: First, we announced the MacBook Pro at MacWorld and began to ship in late February, which limited the number of shipping weeks in the quarter. Second, we observed purchasing delays as some customers are waiting for the remainder of our product announcements. Third, while developer progress on universal applications has been excellent, we believe some customers are delaying purchasing until certain universal applications are available. Customer and industry analyst feedback on the new Intel-based products has been very positive. And we're very enthusiastic about the additional Intel-based Macs that we will be introducing this year.

We have released universal versions of Apple software including iLife, iWorks, QuickTime, Final Cut Studio, Aperture, and Logic. Our third party developers are making excellent progress with our transitions as well, with over 1500 universal applications currently available and commitments from key developers such as Adobe and Microsoft. Our Music business posted another quarter of very strong results, representing 50% of total company revenue and increasing 79% year over year. iPod shipments grew 61% year over year, and we have cumulatively shipped over 50 million. We exited the quarter within our target range of four to six weeks for iPod channel inventory.

Other Music product revenue was 485 million, up 125% year over year, and about flat sequentially with the 14-week holiday quarter. These results were a function of continued strong sales from the iTunes music store, the introduction of the iPod hi-fi, and very solid demand for other iPod accessory products. The iTunes Music Store sold its 1 billionth song during the March quarter. According to the most recent data from Nielson SoundScan, the iTunes Music Store counts for 87% share of the market for legally purchased and downloaded music in the United States.

The music store's U.S. content has continued to expand impressively, and now includes over 2.9 million songs, 60,000 podcasts, 9,000 music videos and over 70 television programs from ABC, NBC, CBS, HBO, ESPN and Showtime. We remain extremely enthusiastic about Apple's music business. Despite a large field of competitors, the most recently published data from NPD Tech World shows that Apple's share of the U.S. market for MP3 players has increased in March to 78% from 71% in December.

The iPod ecosystem continues to thrive, with over 2,000 iPod accessories currently available. There is increasing interest from the automotive industry and we estimate that 40% of new cars sold in the U.S. this year will offer direct iPod integration.

Looking outside the U.S., the iPod is also the top selling MP3 player by a wide margin in the United Kingdom, Japan, Australia, and Canada, based on the latest data from GFK and BCN. In the rest of Europe and Asia, we do not enjoy the same level of market share, and we view this as an opportunity. We are optimistic about further market penetration potential globally and our ability to grow international market share.

Considering penetration rates of other consumer electronic products, the MP3 player market has a lot of room for growth. According to Forrester research, U.S. household MP3 player penetration was less than one quarter of that of digital still cameras as of the end of 2005. Turning to Apple's retail segment, revenue from the Apple retail stores totalled $636 million for the quarter, reflecting the transition to Intel and broader indirect iPod distribution. The new-to-Mac percentage increased to 50% of Macs sold in the store's most recent survey.

We opened six new stores during the quarter, exiting with 141. With an average of 138 stores opened during the quarter, average quarterly revenue per store was 4.6 million. Retail segment profit was 29 million, compared to 42 million in the year-ago quarter, and the associated manufacturing margin not reflected in the retail segment profit was 128 million compared to the 102 million in the year-ago quarter.

Traffic through our retail stores continued to be strong during the quarter, growing from 13 million visitors to 18.1 million visitors, year-over-year and translating to over 10,000 visitors per store per week. Customer interest in the new creative studios was high during the quarter and we delivered over 50,000 one-to-one personal training sessions. We will continue to add new stores at a measured pace and expect to open a total of 40 new stores during fiscal '06. In terms of geographic results, including sales from our retail stores, quarterly revenue in the Americas, Europe, and Japan was up 38%, 37%, and 8% respectively.

Gross margin was 29.8% on a GAAP basis, about 200 basis points higher than our guidance, primarily due to a favorable component pricing environment, higher than expected software sales, and lower than expected costs associated with the Intel transition. Included in GAAP costs of goods sold, was $5 million of stock-based compensation expense. Excluding that expense, non-GAAP gross margin was 29.9%. GAAP operating expenses were 768 million, including $37 million in expense related to stock-based compensation. Non-GAAP OpEx was $731 million, in line with our guidance. OI&E was 76 million and the tax rate was 32%.

We used some of the cash to make several investments during the quarter. First, we made the remaining $500 million prepayments relating to the agreements for future supply of NAN flash memory components that we announced in the December quarter. Second, we net share settled executive income tax obligations from investing of restricted shares and share units by purchasing and canceling about 5.5 million shares for

$353 million. Third, we spent about $120 million to acquire a new data center in the first of several properties to form a second Cupertino campus. Fourth, we made other capital expenditures of $73 million, including $42 million for our retail initiative. Despite these significant investments, cash declined by just $481 million during the quarter to $8.23 billion due to strong earnings, excellent working capital management and stock option exercises. Looking ahead to the June quarter, I'd like to review our outlook which includes the types of forward-looking information that Nancy referred to at the beginning of the call.

From the quarter, we are targeting revenue between $4.2 billion and $4.4 billion. We are factoring into our guidance a continued pause in demand in the Mac business related to the transition to Intel. We are also factoring in lower ASPs for Macs and iPods, due to the beginning of the education buying season and for the full quarter impact of the iPod shuffle price reduction and the introduction of the one gigabyte Nano. We expect total quarterly costs of non-cash stock-based compensation to be approximately 50 million.

We expect GAAP gross margin to be about 28.4%, reflecting approximately $5 million related to stock-based compensation expense. Without that expense, we expect non-GAAP gross margin to be about 28.5%. We expect GAAP OpEx to be $775 million, including about $45 million related to stock-based compensation. We expect non-GAAP OpEx to be about $730 million, similar to the March quarter. We expect OI&E to be about $85 million and we expect the tax rate to be 32%. We expect to generate GAAP EPS of about $0.39 to $0.43, which includes an anticipated $0.04 per share related to non-cash share-based compensation expense. We expect non-GAAP EPS to be about $0.43 to $0.47.

Through the first half of fiscal 2006, Apple has generated over $10 billion in revenue and almost $1 billion in net income. We are very proud to have delivered strong revenue in earnings growth during the transition to Intel. We are extremely happy with how well the transition has been going and we are very enthusiastic about all aspects of our music business. We are confident that our strategy of investing in product innovation is working and we are very excited about the products in our pipeline.

With that, I'd like to open the call to questions.

Nancy Paxton *- Apple Computer - Senior Director IR & Corporate Finance*

May we have the first question please.

QUESTION AND ANSWER

Operator

Yes. [OPERATOR INSTRUCTIONS]. We'll take our first question from Richard Chu of Cowen. Please go ahead.

Richard Chu *- SG Cowen - Analyst*

Hi. Can you hear me?

Nancy Paxton *- Apple Computer - Senior Director IR & Corporate Finance*

We can.

Richard Chu *- SG Cowen - Analyst*

Okay. I wonder if you can talk a little bit more about the gross margin variances. You alluded to component pricing. Can you comment on the impact of these purchases of components either benefiting you or hurting you on that point? And then, second, was mix between systems and iPods a factor at all in the gross margin performance? Thank you.

Tim Cook *- Apple Computer - COO*

Richard, hi, it's Tim. It's -- from a components point of view we were able to secure lower costs than we had planned for the quarter on -- particularly on LCDs and Flash memory and this helped drive the gross margins that Peter talked about in the preamble.

Peter Oppenheimer *- Apple Computer - CFO*

Richard, in terms of your -- the second part of your question there were really three factors. As I indicated that helped us do better on the gross margin. The commodity environment, as Tim alluded to. Also, our software sales were better than we expected. Particularly with the new iLife and iWork applications that we introduced at MacWorld and in our guidance, we contemplated price reductions on some of our transitioning PowerPC products which we largely didn't need to incur.

Richard Chu *- SG Cowen - Analyst*

So mix between iPod and systems was not a variance.

Peter Oppenheimer *- Apple Computer - CFO*

Not a primary one, no.

Richard Chu *- SG Cowen - Analyst*

Okay. Thank you.

Nancy Paxton *- Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Richard. Could we have the next question, please?

Operator

Yes. Next we'll go to Ben Reitzes of UBS.

Ben Reitzes *- UBS - Analyst*

Yeah, good afternoon, thanks. Could you just characterize what's going on with iPod demand? Obviously 8.5 is a big drop-off from the 14.1, and obviously there's seasonality, there was some things with the extra week. Maybe you can go back in time as well and talk about what the extra week might have in hindsight now given you in iPods and then how iPods are going out of the quarter and then, to make this question longer, it seems that based on the ASP there was a drop-off in Nanos a little more than expected. So could you just characterize the state of iPod demand?

Peter Oppenheimer *- Apple Computer - CFO*

Overall, Ben, we are very pleased with the quarter. We shipped 8.5 million iPods and it was up over 60% year over year. The December quarter included a 14th week, and that week fell between Christmas and New Year's. And was one of the better shopping weeks of the -- the year. And so that week sell-through was certainly better than the average of the quarter. And as we discussed in January, we also increased the channel inventory by about 550,000 iPods.

So when you take these factors into account, the sequential iPod sales were down much less than 40%, which according to NPD Tech World has been the typical sequential CE unit decline that you've seen from December to March. So I think the state of the iPods we're very, very happy with it, with the results that we had this quarter. And are excited about what we have in the product pipeline.

Ben Reitzes *- UBS - Analyst*

What is in your guidance for iPods? And maybe more on guidance is you're basically flattish in revenue but yet you -- you should do better in Macs because you may have more units. So if you could just characterize some of the puts and takes between iPods and Macs that went into that guidance.

Peter Oppenheimer *- Apple Computer - CFO*

Okay. Well, as you know, we don't give product level guidance but as I indicated in my prepared remarks, we are factoring into the guidance a continued pause in demand from the transition to Intel. And we're -- included in that are our thinking that some customers may wait for unannounced products, and certain applications becoming universal. And we've also factored lower ASPs into the guidance, both for Mac and iPod as we enter the education buying season, and incur the fourth quarter impact of the Shuffle price decrease and the introduction of the one gigabyte Nano.

Ben Reitzes *- UBS - Analyst*

Okay. And lastly before I go back in the queue, is retail -- you seem to be below expectations and was there some kind of dynamic there where people were buying on-line and -- because of all the preorders of Macs or some kind of dynamic there that held retail sales down?

Peter Oppenheimer *- Apple Computer - CFO*

Well, our retail stores were really focusing on the -- on the transition to Intel. And given our Intel announcement that we made at MacWorld with later delivery, particularly with the MacBook Pro. This limited the number of shipping weeks in the quarter. And this, combined with the overall pause we observed impacted the quarter.

And just to add a little color to that, the retail stores have really been focused on the transition to Intel and immediately upon our announcement that MacWorld, we changed all the product merchandising and the window displays and graphics in the store, really to communicate that this was the future. As Intel-based Macs arrived in the stores, we stopped carrying the comparable PowerPC models and, as you may have seen, our retail sales teams were not discouraged from telling customers to wait for Intel-based Macs if that was the best thing for the customer.

Ben Reitzes *- UBS - Analyst*

Okay. Thank you.

Nancy Paxton *- Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Ben. Could we have the next question, please?

Operator

Yes. Next we'll go to Gene Munster of Piper Jaffray. Please go ahead.

Gene Munster *- Piper Jaffray - Analyst*

Good afternoon, everybody. Just I guess in terms of the iPod market share, can you give us some color what was domestic versus international?

Peter Oppenheimer *- Apple Computer - CFO*

Sure. We have some data that we have from GFK and BCM and NPD. As I indicated, the March NPD data just came out this morning and we were thrilled. Our market share increased to 78%, excuse me, from 71% in the December quarter. And we don't have March data yet internationally, but we do have some February data. Our market share increased in each of these markets from December to February. In the UK we were 40%. Japan was 54%. Canada was 45%, and Australia was 58%.

Gene Munster *- Piper Jaffray - Analyst*

Okay. And I guess on that note, what percentage of your iPod sales are domestic versus international?

Peter Oppenheimer *- Apple Computer - CFO*

Gene, that's something that we just don't discuss, we don't want to help our competitors.

Gene Munster *- Piper Jaffray - Analyst*

Okay. Well, I guess it's safe to say that if you look at some of those other geographies you have a much lower market share as you said, and you mentioned in your prepared comments about just global expansion with the iPod, which is -- sounds nice, but maybe you can talk a little bit about how you're actually going to do that.

Peter Oppenheimer *- Apple Computer - CFO*

Okay. I'll make some comments and Tim may want to add on. If you look outside from the international countries that I referenced, such as Italy and Spain and Eastern Europe and even China and Korea, our market share is much less than what I referenced in those five countries. And we are focused on increasing share by increasing our local advertising and points of distribution. And we have seen some success there. For example, in -- since December in Germany, our share has improved by 10 points, up to 21%. And in France we gained four points up to 11%.

Gene Munster *- Piper Jaffray - Analyst*

Okay. So it's more directly related to advertising versus the pricing of the iPod?

Peter Oppenheimer *- Apple Computer - CFO*

I think it's many things. It's our great product lineup, our distribution, the advertising we're doing, the Music Store.

Gene Munster *- Piper Jaffray - Analyst*

Okay. And on another topic here in terms of the Mac business. I was a little bit surprised to see that the pricing of the Mac mini increased and, granted, you built in a lot more functionality but I would have thought that maybe you guys would have taken advantage of some of those pricing advantages with Intel platform and tried to pass it along to pick up market share, but it seemed like you're going in a little bit different direction. Is it safe to say you're going to kind of continue in that -- the same direction you're going in terms of the pricing, or is every day a new day in terms of potentially where you could go with your pricing?

Tim Cook *- Apple Computer - COO*

Gene, I don't want to comment on our future pricing plans but I would make the point that we viewed the Mac mini as an incredible value. With Mac mini, we began to ship front row for the first time on the Mac mini. It also is the lowest price point to get into the iLife suite. And so overall we think it's a great value for customers.

Gene Munster *- Piper Jaffray - Analyst*

Okay. But is it safe to say that your general thinking about pricing exists in the future or do you think it potentially could change, any thoughts on that front?

Tim Cook *- Apple Computer - COO*

I'm not going to project our future pricing.

Gene Munster *- Piper Jaffray - Analyst*

Okay. One more just housekeeping item here. When -- there's some controversy when the actual back-to-school buying season starts. Is it in May through the end of September? Can you just give us some color on that?

Tim Cook *- Apple Computer - COO*

We generally begin to see some uplift in late June but it's principally in July through September.

Gene Munster *- Piper Jaffray - Analyst*

Okay. So let's just -- I know you guys aren't going to announce timing of products but for example, the iBook, when would that have to be out again? This is not about the exact timing but when would that have to be out to basically really hit the sweet spot of the back to school?

Tim Cook *- Apple Computer - COO*

We're not going to comment on unannounced products.

Gene Munster *- Piper Jaffray - Analyst*

Okay. But any just comments in terms of what the best window for getting the iBook out would be?

Tim Cook *- Apple Computer - COO*

Again, I'm not going to comment on unannounced products.

Operator

Thank you, sir. We'll take our next question from Richard Gardner of Citigroup.

Richard Gardner *- Citigroup - Analyst*

Okay. Thank you. Tim, one for you. I was hoping maybe you could comment on the supply/demand balance for the new Intel-based products that you've launched so far this year exiting the quarter.

And then I guess for Peter, I know we've been talking about seasonality in your guidance for the June quarter throughout the call. But can you just give us a sense of what you consider to be normal seasonality for both the Mac and the Music businesses going into June, excluding some of the product transition and other -- other I guess unusual things that you might have going on? Thanks.

Peter Oppenheimer *- Apple Computer - CFO*

Okay. Rich. How about if I start and then Tim can answer your first question.

Richard Gardner - *Citigroup - Analyst*

Okay.

Peter Oppenheimer - *Apple Computer - CFO*

For the iPod, past seasonal trends are really not applicable this year as prior year's supply constraints particularly with the iPod mini. So we're not sure that we have good historical datapoints to reference. For the Mac, past seasonal trends other than the beginning of the education buying season are also likely to not be as appropriate given our transition to Intel.

Tim Cook - *Apple Computer - COO*

Rich, on the three different products that we announced during the quarter that have Intel processors, the iMac was in reasonable supply the entire quarter. The MacBook Pro, the shipments of the MacBook Pro accelerated in March, February shipments were relatively low. In March the last two weeks of the quarter were particularly strong.

And with those strong shipments, which included a significant amount of units that were in transit at the end of the quarter, we -- we reduced our backlog to normal levels. I would stress again the number of weeks that it was shipping obviously were limited for the quarter. On the Mac mini, we announced that at the end of February and were able to ship that for four weeks of the quarter.

Richard Gardner - *Citigroup - Analyst*

Okay. And then if I could just follow up with one more question. Peter, could you just give us a sense of what the geographic mix is going to be of the 40 new retail stores that you're opening this year?

Peter Oppenheimer - *Apple Computer - CFO*

Primarily in the U.S.

Richard Gardner - *Citigroup - Analyst*

Any sense of how many internationals are included in that?

Peter Oppenheimer - *Apple Computer - CFO*

I think a little more than 30 will be in the United States.

Richard Gardner - *Citigroup - Analyst*

Okay. All right. Thank you.

Nancy Paxton - *Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Rich. Could we have the next question, please?

Operator

Yes. We'll take our next question from Bill Fearnley of FTN Midwest Securities.

Bill Fearnley *- FTN Midwest Securities - Analyst*

Yes, thanks, guys. I'd like to take another crack at the iBook question. With the current product with the G4 processor, do you see having that as your offering going to the K-12 education institution, the selling season or the preselling season for delivery in July through September? Do you think that's going to hurt you in the education business, or do you think you'll be able to sell some of the G4 processors into the education institutions? And then I have a follow-up.

Tim Cook *- Apple Computer - COO*

Bill, again I'm not going to comment on our product plans but I would tell you that we're very proud of the iBook G4 and many customers are continuing to buy it and it's a great product.

Bill Fearnley *- FTN Midwest Securities - Analyst*

Do you think you'd have to take any pricing actions on it, though, to make it more attractive to institutions for later delivery?

Tim Cook *- Apple Computer - COO*

Again I'm not going to comment on pricing or unannounced products.

Bill Fearnley *- FTN Midwest Securities - Analyst*

Okay. Thanks. And also wanted to ask about iPod gross margins. You commented that they were above 20% last call. Could you update on what iPod gross margins were here for the second quarter?

Peter Oppenheimer *- Apple Computer - CFO*

Yes. They were above 20% in the March quarter.

Bill Fearnley *- FTN Midwest Securities - Analyst*

And any comments on mix Nano versus video iPod or anything that you care to comment on for additional color in the iPod space?

Peter Oppenheimer *- Apple Computer - CFO*

Nothing specifically. We were pleased with sales of all of our iPods.

Bill Fearnley *- FTN Midwest Securities - Analyst*

Okay. Thanks.

Nancy Paxton *- Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Bill. Could we have the next question, please?

Operator

[OPERATOR INSTRUCTIONS]. Our next question will come from Chris Whitmore of Deutsche Bank.

Chris Whitmore *- Deutsche Bank - Analyst*

I was hoping to get some color on the split between iBooks and MacBook Pros during the quarter in terms of units sold. And in addition in terms of the inventory levels in the channel, is there any significant difference between desktop inventories in the channel and notebook inventories in the channel?

Tim Cook *- Apple Computer - COO*

Chris, I won't break out the desktop versus portable channel inventory but I will make some comments about channel inventory on the Mac overall. We ended the quarter, as Peter spoke about in the preamble, within the targeted range of four to five weeks. If you recall, we began the quarter with less than four weeks in preparation for the MacWorld announcement. We were able to return to that targeted range by the end of the quarter by increasing the amount of inventory by about five days. And keep in mind that that inventory is in support of indirect sales only.

Chris Whitmore *- Deutsche Bank - Analyst*

And this split between --

Tim Cook *- Apple Computer - COO*

We don't split it out.

Chris Whitmore *- Deutsche Bank - Analyst*

Separate topic regarding flash pricing, flash pricing's coming off fairly sharply here, clearly helps your gross margins in the quarter. What are your thoughts about passing some of those price declines on to customers and accelerating unit growth? Any color on that would be helpful.

Tim Cook *- Apple Computer - COO*

We were able to benefit from flash pricing in the quarter. We did take, if you recall, the Shuffle price down, the entry point, to $69. We also cut the price of the one gig Shuffle to $99, and we announced a new entry point for the Nano at $149. We think all of those are an incredible value.

Chris Whitmore *- Deutsche Bank - Analyst*

Thank you.

Nancy Paxton *- Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Chris. Could we have the next question, please?

Operator

Rebecca Runkle of Morgan Stanley.

Rebecca Runkle *- Morgan Stanley - Analyst*

Great. Thanks. Just a couple of quick questions. First, Peter, on iTunes in particular, I believe you've seen seasonality in the first quarter as school let's out in the past, could you just refresh my own memory in the past in terms of what you've seen in the past.

Peter Oppenheimer - *Apple Computer - CFO*

I'm sorry, for iTunes?

Rebecca Runkle - *Morgan Stanley - Analyst*

Yes. And just music downloads.

Peter Oppenheimer - *Apple Computer - CFO*

Let me make some comments. I think more between December and March and we'll -- we'll see what happens in June and report to you. We were thrilled with our other music sales in the quarter, which were up 125% year over year. And as you know, primarily consists of the iTunes Music Store sales and our iPod and music accessories.

Music sales were actually higher in the March quarter than they were in the December quarter, really showing the momentum that we have in the Music Store around the world. In terms of what you might expect for June, again, we don't give specific product guidance, but we think we are continuing to gain momentum, and sales will vary also quarter by quarter. In part, due to new releases.

Rebecca Runkle - *Morgan Stanley - Analyst*

And then just shifting gears. Can you just talk about how -- and what type of CPU trends you saw as the new Intel CPUs became more available and whether or not you saw people come back into the stores as the supply improved?

Tim Cook - *Apple Computer - COO*

Rebecca, it's Tim. Shipments of the Intel-based Mac accelerated across the quarter, and the majority of the shipments that we did in the month of March were Intel-based, and I think just to pause, there an incredible accomplishment I think to announce a transition in January and have that occur just 60 days thereafter. The customer response that we've gotten is enormous. The analyst response is enormous. And as we saw it, if you look at the adoption rate of percentage of Intel-based units sold to total units, the consumer segment was the highest adoption. And so the stores clearly saw that in the month of March.

Rebecca Runkle - *Morgan Stanley - Analyst*

And then on Boot Camp in particular, any color that you can provide in terms of impact that you saw post that announcement?

Peter Oppenheimer - *Apple Computer - CFO*

You know, the response has been written about a lot. We've had -- we did this because we were getting a lot of customer requests for this, as many Windows users were considering switching to the Mac. We think that it makes the Mac even more appealing to them, and -- but it is beta and so we put that out there to get feedback, and we've really just begun that. It's only been out two weeks.

Rebecca Runkle - *Morgan Stanley - Analyst*

But you would say that just in terms of what you saw from consumers and what you saw flowing to the store, what have you, that it was consistent with what we've seen written about from third parties?

Peter Oppenheimer - *Apple Computer - CFO*

We're seeing a high level of interest in it.

Rebecca Runkle - *Morgan Stanley - Analyst*

Great. Thank you both very much.

Nancy Paxton - *Apple Computer - Senior Director IR & Corporate Finance*

Thanks Rebecca. Can we have the next question, please?

Operator

Our next question comes from Charles Wolf of Needham & Company.

Charles Wolf - *Needham & Company - Analyst*

Yes. I want to stay with Boot Camp. Will Apple add Windows virtualization to the final release in Leopard, or will you leave virtualization to third parties such as Parallel?

Tim Cook - *Apple Computer - COO*

Charlie, we just put it out. It's the beta. We will incorporate it in Leopard as we talked about but the purpose of a beta is to get feedback and I wouldn't want to speculate about what we would or would not do.

Charles Wolf - *Needham & Company - Analyst*

Okay. Now, has the beta downloads in the past two weeks been substantial?

Tim Cook - *Apple Computer - COO*

There is a high level of interest but, again, it's a beta and we're not releasing the download number.

Charles Wolf - *Needham & Company - Analyst*

Okay. Thank you very much.

Tim Cook - *Apple Computer - COO*

Yep.

Nancy Paxton - *Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Charlie. Can we have the next question, please?

Operator

Keith Bachman of Banc of America. Mr. Bachman, your line is open, please go ahead.

Keith Bachman - *Banc of America - Analyst*

Yes, hi, guys. Thanks very much. Peter, Tim, I wanted to go back for a second to the desktop number if I could. The desktop was out for a good part of the quarter, and as you mentioned in the -- in the December quarter, there was a little bit of a pause there in anticipation of the new Intel system. Why do you think the number was still a bit slow? And was it -- are you alluding to the software availability as one of the gating factors there? And I have a follow-up, please.

Tim Cook - *Apple Computer - COO*

Keith, when you look at desk tops, keep in mind that iMac, Mac mini eMac and Power Mac and so we -- as you know, we don't release the specific units on each one of those, but I would share with you that the Intel-based iMac did very well in the quarter. The Mac mini only shipped for four weeks of the quarter or the Mac mini with the Intel version of the Mac mini as we began shipping in March and the compare there is to the launch quarter of a year ago. So it's a very difficult compare. Also, as Peter alluded to, in the preamble, we believe that certain Pro customers are delaying their purchase, waiting on certain apps and the Power Mac would clearly be the unit that would be most affected by the Pro customer delay.

Keith Bachman - *Banc of America - Analyst*

But Tim would it also be the high end of the -- of the i-Mac and if Adobe is publicly indicated that they're not going to have their versions ready natively until '07, how should we be thinking about that impacting? In other words, when do you think the pause ends?

Tim Cook - *Apple Computer - COO*

Well, Adobe has said that their application will be universal with the next release. Casual users of Photoshop may be satisfied with using PhotoShop with Rosetta. A heavy user of PhotoShop would likely not be satisfied with the performance of Photoshop running under Rosetta, and frankly it's very hard to assess the specific impact of it, but we do believe that this is affecting Mac sales and we're working very closely with Adobe to get the creative suite out as soon as possible.

Keith Bachman - *Banc of America - Analyst*

Let me try one last one and then I'll cede the floor. You've indicated you think you might have some additional pause in June and clearly with the Mac or the iBook pending that makes sense, but would that in your mind be the end of any kind of pause at the June quarter?

Tim Cook - *Apple Computer - COO*

I don't want to predict the -- beyond the current quarter and giving guidance for the current quarter.

We are very focused on the -- what we believe are the key factors in getting through the transition and those are: One getting all of our hardware moved and we are on target to do that by the end of the year as we -- as Steve reported earlier at MacWorld. Number two, to get our apps universal and we are pleased to report that the predominant apps in video and audio and our consumer apps are forwarded as of the end of March. Number three is working with our developers. And as Peter said earlier, we've had 1500 that are already universal. And 50% of the top 500 will be by the end of April. And so we feel that this progress in less than 90 days, this enormous progress, that I'm not going to predict when we will get through all of that, other than to say that we are on target on the hardware schedule that we had announced earlier.

Keith Bachman - *Banc of America - Analyst*

Okay. Thanks very much for taking my question.

Nancy Paxton - *Apple Computer - Senior Director IR & Corporate Finance*

Thank you, Keith. Could we have the next question, please?

Operator

Richard Farmer, of Merrill Lynch.

Richard Farmer *- Merrill Lynch - Analyst*

Thank you. Three questions, please. Peter, I will take another crack at the iPod hardware gross margin. You've said that it was over 20%. There are a lot of potential numbers above 20. Can you provide any more color there? Was it for instance closer to 25 than 20?

Peter Oppenheimer *- Apple Computer - CFO*

Richard, I think the only color that I will go into is that it was sequentially better in the March quarter from December and above 20%. As we've indicated before, our competitors would just love to know what our specific gross margins are and shipments by product and by geography and we just don't want to help them.

Richard Farmer *- Merrill Lynch - Analyst*

Okay. Two other brief ones, please. If you look at the observed price declines in the flash contract market, how big of a lag is there typically between those declines and then Apple's ability to take advantage of that pricing in margin in the iPod product?

Tim Cook *- Apple Computer - COO*

We don't really talk about the specifics of our commercial deals, but I would tell you that the advantage that we got on flash pricing during the last quarter was one of the keys behind our gross margin meeting the guidance.

Richard Farmer *- Merrill Lynch - Analyst*

Okay. And then finally a follow-up on Boot Camp. It seems pretty intuitive that there's going to be a portion of consumers that will switch to Mac as a result of the Boot Camp. Corporate in the entrenched Windows environment seems a little bit different. Do you think that Boot Camp is, in any way, going to give you an entree into the traditional corporate Windows environment, particularly if you're not supporting Windows? And I guess the related question is do you anticipate ever supporting Windows directly?

Tim Cook *- Apple Computer - COO*

We have no desire and no plan to sell or support Windows. But we do think that Boot Camp makes the Mac even more appealing to Windows users considering making the switch. And that's the reason we put it out. And it is a beta, and so we have put it out to get feedback and we are just two weeks into that.

Richard Farmer *- Merrill Lynch - Analyst*

Would you agree that that's primarily a consumer-oriented addressable market then, that you're really not targeting given no desire to support Windows directly, you're really not targeting any large corporate Windows environment?

Tim Cook *- Apple Computer - COO*

One of the great advantages of the beta is gathering the customers' feedback and that's where we are in this process.

Richard Farmer - *Merrill Lynch - Analyst*

Okay. Thank you.

Nancy Paxton - *Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Richard. Can we have the next question, please?

Operator

Kevin Hunt of Thomas Weisel Partners.

Kevin Hunt - *Thomas Weisel Partners - Analyst*

Hi. Thanks. I had a couple things. On a technical detail, can you give us the breakout of the 37 million stock option between R&D and SG&A?

And also I had some questions on the margins. This was your highest gross margin in like five years and you've been two quarters in a row over 13% operating margin, which I don't think you were in that high in multiple decades. Can you maybe update us on what the long-term model is that you think you can achieve on a gross margin and operating margin?

Peter Oppenheimer - *Apple Computer - CFO*

Sure. It -- I did not have the breakout with me for the stock comp expense between R&D and SG&A. We did include that last quarter in our press release financials. So you can -- you can go and look at last quarter and get some indication of what it was then. In terms of our margin, I have provided you very detailed guidance for the June quarter, and we're not going to provide an updated business model or future projections and pleased with the -- the guidance that we've given you this quarter, which includes double-digit operating margin.

Kevin Hunt - *Thomas Weisel Partners - Analyst*

I think you -- what I think a while ago, you did kind of give some margin which I thought was only around 10% or so. So is that what you're saying for the long-term sustainable is, or are you saying I think it comes out to something like 11.5 or something what you're saying for the next quarter.

Peter Oppenheimer - *Apple Computer - CFO*

What -- we can clearly see what we've reported, and in terms of our guidance on a GAAP basis, including the stock comp expense, we are at 10% plus, and without the stock for the guidance that we provided for the June quarter, is over 11%.

Kevin Hunt - *Thomas Weisel Partners - Analyst*

Okay. One last question. Did you have any significant discounting of the older G4 models in the quarter?

Peter Oppenheimer - *Apple Computer - CFO*

No. And that was one of the three factors that allowed us to do better on gross margin than what we had guided to. We had planned for some price reductions and many of the transitioning PowerPC models and used very little of it.

Kevin Hunt - *Thomas Weisel Partners - Analyst*

Okay. Thanks.

Nancy Paxton *- Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Kevin. Can we have the next question, please?

Operator

The next question comes from Bill Shope of JP Morgan.

Bill Shope *- JPMorgan - Analyst*

Great. Thank you. Can you give us an outlook -- or your outlook for the component prices in the June quarter and are any components currently constrained?

Tim Cook *- Apple Computer - COO*

There's no significant constraint in the market that we're experiencing. Factored into the guidance that Peter gave you is a favorable pricing environment for both LCD and NAN Flash where supply continues to exceed the demand. We expect optical drives and hard drives to track to historical trends. And DRAM pricing we expect to trade in a relatively narrow range.

Bill Shope *- JPMorgan - Analyst*

Okay. And one more question on a -- there's been a lot of press on the DRAM law proposals in France. Can you give us a read on what you view the potential risks are to the Apple business model longer term and whether you think there is a risk that this could spread to other countries?

Peter Oppenheimer *- Apple Computer - CFO*

Well, we believe that the French implementation of the EU copyright directive will result in state-sponsored piracy and if this happens, we believe legal music sales will plummet just when legitimate alternatives to piracy are winning customers over, and we don't think that the proposed French legislation would be good for anyone.

Bill Shope *- JPMorgan - Analyst*

Okay. And then final question. Can you give us an update on the profitability of the Music Store.

Tim Cook *- Apple Computer - COO*

The Music Store operated above break even in the March quarter.

Bill Shope *- JPMorgan - Analyst*

Great. Thank you.

Nancy Paxton *- Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Bill. Can we have the next question, please?

Operator

Andy Neff of Bear Stearns.

Bill Hand - ***Bear Stearns - Analyst***

Thank you. It's Bill Hand for Andy. Just a couple questions. On the iPod front, I realize you can't talk about new products. But just any thoughts on potential new directions and future drivers for iPod in the second half, other than perhaps maybe market-share gains internationally?

Peter Oppenheimer - ***Apple Computer - CFO***

Well, the question I'm really not able to answer other than to tell you that we are very excited about what we have in the product pipeline. Not for iPod but for Mac and our whole product pipeline.

Bill Hand - ***Bear Stearns - Analyst***

Okay. Just another question regarding the new Mactel product. Are there any particular issues that are holding back the launch of the rest of the Mactel line that you can talk about?

Tim Cook - ***Apple Computer - COO***

We're on target. There's nothing holding it back. We are on target to complete by the end of the year as we have now.

Bill Hand - ***Bear Stearns - Analyst***

Okay. Thank you.

Nancy Paxton - ***Apple Computer - Senior Director IR & Corporate Finance***

Thanks, Bill. Could we have the next question, please?

Operator

Joel Wagonfeld of First Albany.

Joel Wagonfeld - ***First Albany - Analyst***

Thank you. Wanted going into a bit more detail on your expectations for gross margin next quarter you mentioned flash price advantage was a key advantage in your gross margin upside last quarter. What's the relative benefit that you're anticipating for your gross margin guidance for next quarter and what are other key levers that might help or hurt the June quarter that could surprise one way or the other.

Peter Oppenheimer - ***Apple Computer - CFO***

Joel, I'll start and generally talk about the factors that will affect gross margin and Tim may want to add some further color. I guided gross margin down about 140 basis points despite the favorable commodity environment due to several factors: First, the June quarter begins the education buying season. Particularly for K to 12 which buys lower ASP and margin Macs. And secondly, we will see the full quarter impact of the iPod Shuffle price reduction that we took in the introduction of the one gigabyte Nano.

Joel Wagonfeld - *First Albany - Analyst*

In terms of the relative benefit of your Flash advantage, is it about the same as it was last quarter?

Tim Cook - *Apple Computer - COO*

We don't want to get into specifics of that other than to say that we continue to view both LCD and NAN Flash in a very favorable environment for the current quarter.

Joel Wagonfeld - *First Albany - Analyst*

Okay. Thanks.

Nancy Paxton - *Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Joel. Could we have the next question, please?

Operator

We'll ake it from Shaw Wu of American Technology.

Shaw Wu - *American Technology - Analyst*

Thanks. Just any update on use of cash? I mean your cash position continues to build -- well not this specific quarter but any comment there -- any comments on Greenberg Capital? Thanks.

Peter Oppenheimer - *Apple Computer - CFO*

Shaw, regarding our use of cash, we are continuing to be conservative with the cash despite some of the investments we made this quarter. Wanting to retain it for flexibility to invest in the business. We do discuss with the board from time to time share buyback, but don't have a change in philosophy to discuss with you today. As regards Rayburn, we are opening an office in Nevada as part of our treasury operations. In addition to our offices in Cupertino and Singapore.

Shaw Wu - *American Technology - Analyst*

That's it? Thanks.

Nancy Paxton - *Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Shaw. Can we have the next question, please?

Operator

Steve Lidberg of Pacific Crest Securities.

Steve Lidberg - *Pacific Crest Securities - Analyst*

Good afternoon. First I was hoping that you could provide kind of a sense as to the Mac units and what percentage of them were Intel-based systems and then secondly, as you look at the iPod business I guess, where are the points of presence -- or with is the number for points presence today? And how is that situated between the U.S. market and the international markets? Thanks.

Tim Cook - ***Apple Computer - COO***

Hi, Steve, it's Tim. The -- we're not releasing the exact percentage of Intel versus PowerPC for the quarter of the Mac area. But I can tell you that the shipments of the Intel units did accelerate across the quarter and the majority of shipments that we made in the month of March were Intel-based. In regards to the iPod points of presence, we now have over 35,000 store fronts across the world.

We believe that we are at or near full distribution in the U.S., and some countries in Europe. But we believe there's still opportunity in other countries in Europe, in Japan and Asia and Latin America and Canada. And so we're continuing to find and sign very good channel partners.

Steve Lidberg - ***Pacific Crest Securities - Analyst***

Thank you.

Nancy Paxton - ***Apple Computer - Senior Director IR & Corporate Finance***

Thanks, Steve. Could we have the next question, please?

Operator

We'll take the next question from Harry Blount of Lehman Brothers.

Harry Blount - ***Lehman Brothers - Analyst***

Thank you. A couple questions. First of all on the PC unit side of the equation, it looks like you had good growth year over year in Europe and was wondering if that may be related to additional distribution locations on the PC?

Tim Cook - ***Apple Computer - COO***

The difference in the Europe's overall year-over-year growth versus the Company's was principally an increase in channel inventory related to MacBook Pro units being in transit at the end of the quarter that I had spoken about earlier. And so the growth rate looks very similar to the rest of the world.

Harry Blount - ***Lehman Brothers - Analyst***

And then related to that, how many Mac locations do you currently have?

Tim Cook - ***Apple Computer - COO***

We currently have around 7,000 around the world.

Harry Blount - ***Lehman Brothers - Analyst***

And then just in terms of trends between direct and indirect. Can you give some sense of how iPods and PCs have trended over the last several quarters?

Peter Oppenheimer - ***Apple Computer - CFO***

We don't break iPod and Mac direct, indirect out but our direct sales in the March quarter were 44% and in that we include direct sales to education and enterprise customers on-line, retail and our Music Store.

Harry Blount - ***Lehman Brothers - Analyst***

Okay. And then the last question also relates to PC distribution. I understand what you guys were saying upfront in terms of the Intel stall, but if I look at the retail units, PC retail units sold even on a year-over-year basis, given that you guys have maybe three or four dozen more stores open, it would actually suggest that the PC units per store are down fairly meaningfully on a year-over-year basis. Is -- it's -- I guess it seems counterintuitive that the stores would be the place that people would be most likely to convert given the support that they have and the selection of inventory. So a little bit more thoughts on that would be helpful.

Peter Oppenheimer - ***Apple Computer - CFO***

Sure. And as I commented earlier, our retail stores are really focusing on the Intel transition. And we made announcements at MacWorld and shipped -- and delivered product later, particularly with the MacBook Pro. And this impacted our stores. And again, the stores were really focused from a Mac perspective on the transition to Intel.

We very quickly changed the merchandising and the window displays and the graphics to focus on the Intel transition right after MacWorld in advance of product coming to the stores, as our first Intel-based Macs arrived in the stores, we generally stopped carrying the PowerPC based models. And as you may have seen, as I indicated, our sales teams really didn't discourage people from waiting for Intel-based models to arrive and really let the customer purchase what they wanted to and that impacted us in the quarter. We remained very, very confident in our retail stores, they are delivering strong growth to the Company and our new-to-Mac percent in the quarter actually rose to about 50%.

Harry Blount - ***Lehman Brothers - Analyst***

One last question. I meant to come back to the margin side real quickly. You guys had started several quarters ago the royalty licensing program and obviously that's a contribution to margins as well. You didn't mention that. And so I'm wondering as it relates to iPod margins overall, was that a contributing factor?

Peter Oppenheimer - ***Apple Computer - CFO***

I am sorry, Harry, I can't comment on that. Those agreements have -- are confidential.

Harry Blount - ***Lehman Brothers - Analyst***

Thank you.

Nancy Paxton - ***Apple Computer - Senior Director IR & Corporate Finance***

Thanks. Can we have the next question, please?

Operator

We'll take the next question from Shannon Cross of Cross Research.

Shannon Cross - ***Cross Research - Analyst***

Hi, good afternoon. Just a question on your new facility. Any idea what you're going to spend on CapEx for that? I think you said $120 million was for the data center which I think Steve mentioned you'd put together like nine parcels or something? And then also the 3000, 3500 employees, are those incremental to your head count do you think or is that just consolidating Cupertino?

Peter Oppenheimer *- Apple Computer - CFO*

Let me go back through that. In the quarter we spent about 120 million to acquire a new data center to support our future growth. And the first of several properties for a second campus in Cupertino. As a result of the growth that we've had, we have increased the number of leased buildings in the greater Cupertino area. And this has become really much less efficient and very inconvenient for us.

So we've gone out and are in the process of acquiring about 50 acres that are just about 10 minutes away from our current campus. And we expect to break ground in a few years and hopefully complete a second campus in around four years and we very much look forward to getting our teams closer together. So the idea would really be to consolidate the teams that we have into two campuses. We have about 30 buildings scattered across Cupertino that the people are in.

Shannon Cross *- Cross Research - Analyst*

Okay. How many employees work at the one campus right now?

Peter Oppenheimer *- Apple Computer - CFO*

We have many thousand employees here in Cupertino but aren't disclosing how many are on the campus.

Shannon Cross *- Cross Research - Analyst*

Okay. And then moving on. Profitability of iTunes, are you still running for break even? What are your thought processes as you obviously have expanded the content significantly?

Peter Oppenheimer *- Apple Computer - CFO*

As I commented before, the store operated above break even in the quarter and we think selling songs and video is really helping us to sell iPods.

Shannon Cross *- Cross Research - Analyst*

Okay. And then one final question. Can you just clarify the retail profit -- yes, just the profit from your retail stores this quarter?

Peter Oppenheimer *- Apple Computer - CFO*

Sure. The segment profit was 29 million and the manufacturing margin was not included in the segment profit was 128 million.

Shannon Cross *- Cross Research - Analyst*

Okay. Thank you.

Nancy Paxton *- Apple Computer - Senior Director IR & Corporate Finance*

Thanks, Shannon. We have time for one more question.

Operator

Our last question will come from David Bailey. Please go ahead, sir.

David Bailey - *Goldman Sachs - Analyst*

Yes, thank you. Just a quick clarification. Did you say that you increased iPod channel inventory by 550,000 units in the December quarter and can you tell us how many units you -- if any that you added in the March quarter?

Tim Cook - *Apple Computer - COO*

David, we did increase channel inventory in the December quarter by 550. As we entered the quarter, we were within the targeted range of four to six weeks on a look-forward basis and as we exited the quarter, we were within that range. And also the number of weeks is approximately the same in both cases.

Nancy Paxton - *Apple Computer - Senior Director IR & Corporate Finance*

Okay. Thank you, David. And thanks, everyone, for joining us.

Recording of today's call will be available for retail for seven days beginning at 5 p.m. Pacific time today, and the number for that replay is 719-457-0820. Confirmation code is 4955780. A replay of the audio webcast for this call will also be available beginning at approximately 5 o'clock Pacific time today at www.apple.com/investor. And members of the press with additional questions can contact Steve Dowling at 408-974-1896, and financial analysts can contact Joan Hoffer or me with additional questions, Joan's at 408-974-4570 and I'm at 408-974-5420. Thanks again for joining us.

Operator

Ladies and gentlemen, that does conclude our presentation. We do appreciate your participation. At this time you may disconnect.

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